



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PPD 730.5.17.1

September 8, 2005
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MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Financial Condition Risk Assessments and Financial Capability Audits at Parent and Subsidiary Locations

Summary

Financial condition risk assessments and financial capability audits should generally be performed at the level of the parent company (corporate home office) rather than at each individual segment/subsidiary. Auditors at the parent company have the responsibility to request audit assistance from the subsidiary level auditors when necessary. There are generally two exceptions where the risk assessment and audit will be initiated and performed at the subsidiary level: (1) DCAA does not have access to the parent company or (2) the parent company does not guarantee the subsidiary's performance **and** the parent company does not obtain the subsidiary's cash (referred to as a "cash sweep"). Enclosed is a table summarizing the guidance. This guidance is effective starting in FY 2006.

Background

Assessing contractor financial capability where parent/subsidiary relationships exist present various challenges. Potential solutions were discussed at several recent Executive Steering Committee meetings. Policy also obtained regional input on the approach and location of the risk assessment or audit under a number of parent/subsidiary scenarios. This guidance was developed after consideration of this input, potential Government risk, and the effective use of Agency resources.

One of the factors complicating a financial condition risk assessment and financial capability audit is when the parent company obtains the cash of the subsidiary on a regular basis. In some instances, the cash is taken on a daily or weekly basis or some other frequency. The taking of cash from the subsidiary on a regular basis is referred to as a "cash sweep" throughout this guidance. Our review of the common characteristics of cash management plans with cash sweeps has generally shown that the cash needs of any subsidiary with negative cash flows have been timely met by the parent company. Moreover, usually the parent company maintains close scrutiny of subsidiaries that consistently require infusions of cash to meet operating expenses. Thus, the risk of a subsidiary failing to meet its near term cash needs and to financially perform on a Government contract is significantly reduced as long as the parent company (1) is in a positive cash position, (2) has access to needed credit facilities to supplement corporate cash reserves, and (3) consistently supports the cash needs of its subsidiaries. Under these circumstances, we can rely on the consistent and effective use of these plans, analyzed at the

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parent location, to effectively reduce the risk to the Government, while expending the appropriate amount of audit resources.

Guidance – Level to Perform Risk Assessments and Audits

Financial condition risk assessments and financial capability audits should generally be performed at the level of the parent company (corporate home office) rather than at each individual segment/subsidiary. Given that data has shown that a parent company with good financial health is unlikely to permit the financial failing of a subsidiary on Government contracts, Agency policy has been revised to limit the risk assessments and audits to the parent company. Auditors at the parent company have the responsibility to request audit assistance from the subsidiary level auditors when necessary. There are generally two exceptions where the risk assessment and audit will be initiated and performed at the subsidiary level.

Exceptions – Risk Assessment and Audits Performed at Subsidiary

1. DCAA does not have access to the parent company. Where DCAA does not have access to the parent company, the risk assessments and audit will be performed at the subsidiary level using the guidance at CAM 14-304. Access is defined for purposes of this guidance as parent companies where incurred cost audits are performed. The scope of the risk assessments at the parent company is based on whether the parent is publicly traded, or upon the availability of other public information that the auditor can use to assess risk at the parent.

Parent is a public company. Auditors should use the financial data presented on the U.S. Securities and Exchange Commission (SEC) website at www.sec.gov. Auditors will rely upon this published contractor financial data to perform any required risk assessment of the parent. In doing so, auditors should also make note of the type of audit opinion being rendered on the financial statements by the independent public accountant (IPA), other comments/notes contained in the published financial statements, and any going concern comment (SAS 59) made by the IPA. If financial distress is disclosed at the parent location using the public information, a qualification to the subsidiary report should be considered.

Parent is a nonpublic company. Auditors should normally not pursue access to the financial records of the parent company unless (1) total Government dollars at the subsidiary location(s) are significant, (2) the parent sweeps cash or guarantees the subsidiary's performance, and (3) the auditor has indicators of potential financial distress of the parent. Unless all three of these key elements exist, auditors will only perform a risk assessment and/or audit at the subsidiary location. If, while performing the risk assessment at the subsidiary, the auditor identifies that the parent performs cash sweeps as part of a corporate cash management plan, the subsidiary risk assessment should not include the analysis of financial ratios since they normally are distorted by the lack of cash on the books of the subsidiary. In lieu of a ratio analysis, the auditor should consider analyzing other financial data such as a trending of sales, profitability, debt, and equity amounts (CAM 14-304e.), as well as consider other relevant information (CAM 14-304g.). When access to the parent company is

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not obtained or pursued, qualify the audit report (if an audit is performed at the subsidiary) for the lack of access to the parent.

2. The parent company does not guarantee the subsidiary's performance and the parent company does not take the subsidiary's cash. In instances where there is no guarantee of subsidiary performance on significant Government contracts from the parent company and the parent company does not take the cash of the subsidiary (both conditions met), the risk assessment and audit are performed at **both** the parent and subsidiary levels using the guidance in CAM 14-300 (provided DCAA has access to the parent company). Since the subsidiary is responsible for the performance on Government contracts and the parent company does not have involvement with the subsidiary's cash management, the risk assessments and audit are performed at the subsidiary level. The risk assessments and audit are also performed at the parent level to ensure that the financial health of the parent does not have a negative impact on the subsidiary's performance on Government contracts.

Guidance – Additional Procedures to be Performed at Parent Company Locations with a Cash Management Plan Where DCAA has Access

In light of the revised Agency policy on limiting the risk assessments and audits to the parent company, additional procedures need to be performed by the auditors at the parent company related to the cash management plan. Revised audit program steps in are in the process of being developed and will be distributed shortly. In the meantime, auditors should follow the general guidance presented in this section when assessing the cash management plan at the parent company.

When cash sweeps of subsidiaries are part of a corporate cash management plan, parent auditors (where the auditor has access) will perform the risk assessment that will cover all subsidiaries with Government contracts, and determine during this assessment whether any assistance or effort is necessary from the auditors at the subsidiary location(s). The nature and purpose of most cash management plans is for the parent to centralize the management of the financial health of the entire corporation at the parent location. This centralization affords DCAA the opportunity, through a risk assessment conducted at one location, to rely upon the provisions of the plan, and the parent's administration of it, to provide assurance that the near-term financial requirements of all subsidiaries with Government contracts are met.

Parent auditors will review the cash management plans and assess the contractor's processes, controls, procedures, and management reporting mechanisms used for ensuring that the cash needs of any subsidiaries with Government contracts are being met. Through this analysis, the parent company auditors will be able to verify through company documentation:

- whether a subsidiary is a consistent generator or user of cash,
- parent company actions taken to support the subsidiary's (cash user's) financial needs,
- how often a given subsidiary needs cash infusions from the parent,
- the magnitude of funds being used by the subsidiary, and

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- how such funds are being accounted for (e.g., intercompany loans, equity reduction of subsidiary, etc.).

If a subsidiary is using more funds than it is generating, (i.e., it is a cash user), the parent company auditors will consult with the subsidiary auditors, and jointly determine the need for a risk assessment or audit to be performed at the subsidiary. In performing the risk assessment, the auditors will continue to follow the audit guidance and procedures covered in CAM 14-300.

Implementation of this guidance depends upon the parent auditors' ability to timely obtain and adequately understand and review the corporate cash management plan and related data. Customer requests for a risk assessment in the interim, should be handled on a case-by-case basis and reflect the best available data and approach.

FAOs should coordinate with the regional office when circumstances arise that are not discussed in this guidance to ensure the risk and effective use of Agency resources are appropriately considered. Auditors with questions should address them to their regional office. Regional questions concerning this memorandum should be directed to Program Manager, Policy Programs Division, at (703) 767-2270.

/Signed/

Robert DiMucci
Assistant Director
Policy and Plans

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Enclosure

Decision Table – Performing Financial
Condition Risk Assessment and Financial
Capability Audits at Parent and Subsidiary Locations

Decision Table
Performing Financial Condition Risk Assessments and
Financial Capability Audits at Parent and Subsidiary Locations

Scenario	Who signs contract?	Access to parent *	Parent guaranty	Cash sweep	Location to Perform Risk Assessment and/or Audit
1	Parent	√	N/A		Parent
2	Parent	√	N/A	√	Parent
3	Subsidiary				Subsidiary
4	Subsidiary		√		Subsidiary. Abbreviated review at parent using publicly available data. Access to non-public parent pursued based on risk. **
5	Subsidiary			√	Same as Scenario 4 above.
6	Subsidiary		√	√	Same as Scenario 4 above.
7	Subsidiary	√			Parent and subsidiary.
8	Subsidiary	√	√		At parent since parent is guaranteeing subsidiary's performance.
9	Subsidiary	√		√	At parent, because parent's control of cash shifts subsidiary's cash dependence to parent. Parent auditors, in consultation with the subsidiary auditors, determine requirement for risk assessment at subsidiary.
10	Subsidiary	√	√	√	Same as Scenario 9 above.

* Access to the parent, for purposes of this guidance, is defined as parent company locations where DCAA performs incurred cost audits.

** If Government dollars are not significant at subsidiaries, qualify the audit report (if an audit is performed at the subsidiary) for the lack of access to the parent. Pursuit of access to records at the parent will be undertaken only if the parent is not publicly traded, total Government dollars at the subsidiary location(s) are significant, the parent sweeps cash or guarantees the subsidiary's performance, and the auditor has indicators of potential financial distress of the parent.